DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0391
Indiana Corporate Income Tax
For the Tax Year 2003

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ISSUES

I. **Adjusted Gross Income Tax**—Business/Non-Business Income.

Authority: IC § 6-3-2-2; IC § 6-8.1-3-3; IC § 6-8.1-5-1; *Wabash Inc. v. Indiana Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000).

Taxpayer protests the Department's decision to reclassify certain of Taxpayer's non-business income as business income.

II. **Tax Administration**—Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayer protests the imposition of negligence and underpayment penalties.

STATEMENT OF FACTS

Taxpayer is a multi-structured manufacturing business consisting of a parent corporation ("parent") and several subsidiaries. Taxpayer filed a consolidated Indiana adjusted gross income tax return including its parent and subsidiaries that had activities in Indiana for the tax year 2003. Pursuant to a desk audit for the tax period 2003, the Indiana Department of Revenue (Department) assessed additional adjusted gross income tax, penalties, and interest. The Taxpayer protested the assessment. An administrative hearing was held, and this Letter of Findings results.

I. **Adjusted Gross Income Tax**—Business/Non-Business Income.

DISCUSSION

Pursuant to IC § 6-8.1-5-1(c), all tax assessments are presumed to be accurate, and the taxpayer bears the burden of proving that an assessment is incorrect.

Taxpayer protests the Department's decision to reclassify Taxpayer's parent's non-business interest expense as a business interest expense. Taxpayer reported an interest expense deduction for its parent as a non-business expense resulting in a non-business loss. The Department reclassified this interest expense deduction as a business expense.

Taxpayer asserts that the classification of the expense as business or non-business is not relevant. Taxpayer maintains that it classified the expense as non-business on its Indiana income tax return because it was relying on a "Departmental ruling" it received in 1985. Taxpayer claims that a letter it received from the Commissioner in 1985 relating to the protest of a refund request denial is a "Departmental ruling" that interprets a listed tax and requires the Department to follow the "removal of expired rules" procedure under IC § 6-8.1-3-3.

IC § 6-8.1-3-3 provides:

> (a) The department shall adopt, under IC 4-22-2, rules governing:
> (1) the administration, collection, and enforcement of the listed taxes;
> (2) the interpretation of the statutes governing the listed taxes;
> (3) the procedures relating to the listed taxes; and
> (4) the methods of valuing the items subject to the listed taxes.
> (b) No change in the department's interpretation of a listed tax may take effect before the date the change is:
> (1) adopted in a rule under this section; or
> (2) published in the Indiana Register under IC 4-22-7-7(a)(5), if IC 4-22-2 does not require the interpretation to be adopted as a rule; if the change would increase a taxpayer's liability for a listed tax.
> (c) The department shall furnish copies of its rules and statements described in subsection (b)(2) to the public at a cost equivalent to the preparation and mailing costs of those rules or statements. However, the department shall furnish the rules or statements, on request, free of charge to governmental officials of any state or of the federal government.

The Department does not agree that the 1985 letter is subject to the provisions of IC § 6-8.1-3-3. However, even if the Commissioner's 1985 letter is a "Departmental ruling" subject to the rules under IC § 6-8.1-3-3, the ruling does not discuss the business or non-business status of Taxpayer's interest expense, but addresses Taxpayer's apportionment method. The letter provides, as follows:

> Please let this letter serve as official notification that I am ruling in favor of your client, [Taxpayer]. This ruling **allows** [Taxpayer] to combine its one-hundred percent apportioned taxable adjusted gross income with less than one-hundred percent apportioned taxable adjusted gross income of its two subsidiaries corporation. (**Emphasis added**).

Accordingly, this "Departmental ruling" gives Taxpayer the choice to report its income in a "modified stacked method," which means combining the parent's one-hundred (100) percent allocated Indiana income with its two subsidiaries apportioned Indiana income. The Department's letter allowed Taxpayer the choice of reporting its income this way based upon Taxpayer's interpretation of IC § 6-3-2-2(b), as in effect in 1985.

IC § 6-3-2-2(b), as in effect in 1985, provided:

> Except as provided in subjection (1), if business income of a corporation or a nonresident person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and

> without the state of Indiana by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three [3].

Taxpayer reasoned that since its parent corporation is located and performs its activities one hundred percent in Indiana, it is does not have income from sources within and without Indiana subjecting the income to apportionment.

However, Taxpayer has not relied on this letter because it has apportioned its parent's Indiana source income (except for the "non-business expense" deduction) in the 2003 tax year and every tax year since at least 1990. Taxpayer wishes to have a best of both worlds approach to report its parent's income source income—if the parent has income its apportioned at twenty-three percent and an expense is unapportioned and comes in at one-hundred percent.

Additionally, the Tax court in *Wabash Inc. v. Indiana Dep't of State Revenue*, 729 N.E.2d 620 (Ind. Tax Ct. 2000), addressed a similar situation that refutes Taxpayer's reasoning. In *Wabash,* the court found that the standard apportionment method is the most appropriate method because "in a consolidated return the separate entities are disregarded; the consolidated group is reported on a single return and a single tax is paid on the total income." *Id*. at 625-6. The court noted that "[t]he spirit and intent of a consolidated adjusted gross income tax return is to treat an affiliated group as a single taxpayer." *Id.* at 626.

Accordingly, when Taxpayer is viewed as a single taxpayer with the separate entities disregarded, Taxpayer has income from both sources within Indiana and without Indiana and its income is subject to apportionment. Therefore, since Taxpayer's Indiana source income should be apportioned, any Indiana source business income or expense is subject to apportionment. Since the interest expense is a business expense, it is subject to apportionment with the rest of the parent's Indiana source income.

Consequently, Taxpayer has asked that in the event that its protest is denied that the Department give the issue prospective treatment. Taxpayer reasons that Taxpayer has been reporting the parent's Indiana adjusted gross income this way for several years, and the Department had failed to take action until now. However, this specific reporting situation was brought to the legal department's attention for the first time when the situation was noticed during a desk audit that arose out of an unrelated matter. Therefore, Taxpayer has not met its burden of proof providing sufficient justification warranting prospective treatment.

FINIDNG

Taxpayer's protest is respectfully denied.

II. **Tax Administration**—Negligence Penalty.

DISCUSSION

Taxpayer protests the imposition of the ten (10) percent negligence penalties for the tax years in question. The Department refers to IC § 6-8.1-10-2.1(a)(3), which provides "if a person . . . incurs, upon examination by the department, a deficiency that is due to negligence . . . the person is subject to a penalty."

The Department also refers to 45 IAC 15-11-2(b), which states:

> Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive the negligence penalty as provided in 45 IAC 15-11-2(c), as follows:

> The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
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> (1) the nature of the tax involved;
> (2) judicial precedents set by Indiana courts;
> (3) judicial precedents established in jurisdictions outside Indiana;
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
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> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has provided sufficient information to establish that its failure to pay the deficiency was not due to Taxpayer's negligence, but was due to reasonable cause as required by 45 IAC 15-11-2(c).

FINDING

Taxpayer's protest is sustained.

AB/WL/DK-October 4, 2007